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THE ROLE OF INDEPENDENT DIRECTORS IN MITIGATING LIABILITY ARISING FROM RESTRUCTURING DECISIONS

In this article the authors begin by discussing the law relevant to board decision-making when a corporation is in distress, the fiduciary duties of directors, and the important role of the independent director in the bankruptcy process. They then turn to detailed discussions of the recent D&O litigation challenging restructuring decisions in the Toys "R" Us and SportCo Holdings chapter 11 plans. They conclude with steps boards can take to mitigate the risk of liability in connection with negotiating and approving restructuring transactions.

By Michael R. Handler and Arthur J. Steinberg *

Corporate restructurings usually have one thing in common — rarely are *all* the stakeholders happy with the result. This is particularly true in a bankruptcy proceeding involving significant creditor loss. Moreover, in a bankruptcy proceeding where the debtor's tangible assets are encumbered by liens, it is likely that unsecured creditors' only hope for recovery is from litigation claims constituting property of the debtor's estate ("estate causes of action") which are typically unencumbered. A frequently asserted estate cause of action involves a transfer of assets from the debtor to insiders for less fair market value or no consideration. In that scenario, the commentary on distressed company governance focuses on the role of the independent director in reducing liability for these types of claims. In contrast, recent litigation against the board of directors ("Board") brought by trustees formed by the *Toys "R" Us* and *SportCo Holdings* chapter 11 plans highlights a different fact pattern arising from decisions made by those Boards with respect to the structure and terms of the restructuring itself. This article describes the law relevant to Board decision-making when a corporation is in distress, the relevant D&O litigation arising in *Toys R Us* and *SportCo Holdings*, and concludes with steps Boards can take to mitigate the risk of liability in connection with negotiating and approving restructuring and restructuring-related transactions.

BACKGROUND: DISTRESSED COMPANY GOVERNANCE AND APPLICABLE LAW

The internal affairs doctrine provides that "the law of the state where a corporation is incorporated governs issues relating to the internal affairs of a corporation, which include issues relating to a corporations' directors' and officers' fiduciary duties."[1] The *primary* fiduciary duties of directors and officers are the duty of care and the duty of loyalty. The duty of care obligates every corporate director and officer to discharge duties to the corporation with the same diligence, care, and skill which ordinary prudent persons exercise in their personal affairs. Under Delaware law, directors owe a

[1] *In re Hydrogen, L.L.C.*, 431 B.R. 337, 346 (Bankr. S.D.N.Y. 2010).

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fiduciary duty to the company and its equity holders.[2] This means they must exercise their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[3] In the *SportCo* and *Toys "R" Us* chapter 11 cases (discussed below), the relevant debtor corporate entities were governed by Delaware law.

Under Delaware law, when a corporation is insolvent, the Board's fiduciary duties shift such that they must also take into consideration the interests of the corporation's creditors, "as the residual beneficiaries of any increase in value."[4] "The corporation's insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value."[5] Note that "[t]he stockholders remain residual claimants, but they can benefit from increases in the corporation's value only after the more senior claims of the corporation's creditors have been satisfied."[6] Although directors of an insolvent corporation must take into consideration the interests of creditors in connection with maximizing the value of the enterprise, the substantive duties are still owed to the corporation and not the creditors themselves. Practically speaking, this means that the Board of an insolvent corporation may still pursue "value maximizing strategies" on the riskier end of the spectrum if it still would otherwise satisfy the business judgment standard.[7]

Both outside and inside of bankruptcy, the standard of review as to whether a director and/or officer took corporate action consistent with his or her fiduciary duties depends on whether the corporate fiduciaries were economically interested in the transaction being reviewed (i.e., free from conflict). The most deferential standard of review is the "business judgment rule" under which there "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[8] The business judgment rule "shields corporate decision-makers and their decisions from judicial second-guessing when the following elements are present: '(1) a business decision, (2) disinterestedness, (3) due care, (4) good faith, and (5) according to some courts and commentators, no abuse of discretion or waste of corporate assets.'"[9] Courts apply a "heightened scrutiny" test in assessing the bona fides of a transaction among a debtor and an insider of the debtor. "In applying heightened scrutiny, courts are concerned with the integrity and entire fairness of the transaction at issue, typically examining whether the process and price of a proposed transaction not only appear fair but are fair, and whether fiduciary duties were properly taken into consideration."[10] Where "heightened scrutiny" is applied, the "independence" and "disinterestedness" of the independent and disinterested director(s) authorizing the debtor to proceed with the proposed transaction, as well as the process the independent director(s) employed to evaluate the transaction, are critical factors in the post-decision scrutiny of the transaction.

In order to ensure that Board decision making will be evaluated under a "business judgment" standard and otherwise mitigate the risk of allegations of self-dealing

[2] *See, e.g.*, *Quadrant Structured Prods. Co.. Ltd. v. Vertin*, 102 A.3d 155, 184 (Del. Ch. 2014) ("A transfer of value from a solvent subsidiary to the holder of 100% of the equity cannot give rise to a fiduciary wrong."); *Official Comm. of Unsecured Creditors v. Meltzer*, 589 B.R. 6, 27 (D. Me. 2018) ("Remember that it is acceptable, even required, for the directors of a solvent wholly-owned subsidiary to serve its parent's interests.").

[3] *Prod. Res. Gp., L.L.C. v. NCT Gp., Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004) ("Having complied with all legal obligations owed to the firm's creditors, the board would . . . ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.").

[4] *Quadrant*, 102 A.3d at 184.

[5] *Id.* at 172.

[6] *Id.* (internal citations omitted).

[7] *Id.* at 187.

[8] *See, e.g., In re Latam Airlines Group S.A.*, 620 B.R. 722, 768 (Bankr. S.D.N.Y. 2020).

[9] *Id.* (emphasis added).

[10] *In re Innkeepers USA Tr.*, 442 B.R. 227, 231 (Bankr. S.D.N.Y. 2010).

and/or a compromised decision-making, one of the first action items on the checklist of any sophisticated Board is ensuring there is at least one "independent" director sitting on the Board.[11] Appointment of an independent director is especially important if a bankruptcy filing is imminent, as all non-ordinary course transactions (e.g., asset sales, new employee compensation programs or modifications thereto, new financing arrangements or modifications thereto), especially transactions with "insiders" and other related parties, will be scrutinized by creditors and, in some cases, a chapter 11 trustee or examiner.

The role of the independent director on the Board of a distressed company prior to bankruptcy will vary based on facts and circumstances. At a minimum, the independent director will typically take the lead in making recommendations with respect to related party/insider transactions. In connection with preparing for a chapter 11 filing, the independent director may also take the lead on overseeing and communicating with restructuring advisors, negotiating with funded debt creditors on relevant prepetition agreements (such as debtor-in-possession financing and a restructuring support agreement), and crafting a communications strategy with employees, vendors, and customers related to the chapter 11 filing. The use of an independent director and/or special committee of the Board alone does not automatically protect the Board from a higher degree of scrutiny. The independent director and/or special committee must have actual bargaining power without interference and the real ability to decide whether to accept or reject the terms of an offer.[12]

In a chapter 11 bankruptcy case, the debtor automatically assumes an additional identity as the "debtor in possession."[13] A debtor will remain a debtor in possession until the debtor's plan of reorganization is confirmed and goes effective, the debtor's case is dismissed or converted to chapter 7, or a chapter 11 trustee is appointed. The appointment or election of a trustee occurs only in a small number of cases. Generally, the debtor, as "debtor in possession," operates the business and performs many of the same functions that a trustee would perform.[14] In addition to an independent director, the appointment of a chief restructuring officer may also protect against the appointment of a trustee or examiner. The concept of allowing the debtor to remain in possession is "premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee."[15]

RECENT CHAPTER 11 LITIGATION CHALLENGING RESTRUCTURING DECISIONS

Ongoing litigation arising from the Toys "R" Us" and SportCo Holdings chapter 11 cases brought by litigation trustees acting on behalf of unsecured creditors against directors relating to restructuring-related decisions underscore the importance of (1) the involvement of independent directors in analyzing and making restructuring decisions on behalf of the Board and (2) developing a robust record of critical and independent analysis in support of such decisions.

SportCo Holdings

In June of 2019, SportCo Holdings, Inc. and various affiliates (collectively, "SportCo") filed for chapter 11 in the Delaware Bankruptcy Court. SportCo was a marketer and distributor of hunting and fishing products and accessories that faced various financial and operational challenges, which were compounded by SportCo's acquisition of the assets of competitor AcuSport Corporation. The chapter 11 filing was preceded by, among other thing, an unsuccessful going concern sale process and, as discussed below, a failed out-of-court restructuring negotiation between SportCo and the holders of its Term Loan Debt (defined below).[16]

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[11] The term "independent director" does not have a firmly established definition in the context of state and bankruptcy law, but in substance, it is a director with no material relationship (personal or financial) with the corporation. American College of Bankruptcy Program, Oct. 5, 2021, "Independent Directors,CROs and Examiners: Managing Conflicts in Multi-Debtor Chapter 11 Mega-Cases."

[12] *See, e.g., Rabkin v. Olin Corp.*, No. 7547, 1990 WL 47648, at *861-62 (Del. Ch. Apr. 17, 1990), aff'd 586 A.2d 1202 (Del. 1990); *In re First Boston, Inc. S'holder Litig.*, No. 10338, 1990 Del. Ch. LEXIS 74 (June 7, 1990).

[13] 11 U.S.C. § 1101.

[14] 11 U.S.C. § 1107(a).

[15] *Wolf v. Weinstein*, 372 U.S. 633, 651 (1963) ("[S]o long as the Debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligation to the creditors as does the trustee . . . .").

[16] All background information related to SportCo was pulled from the Declaration of Bradley P Johnson in Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, *In re: SportCo Holdings, Inc., et al.,* No. 19-11299-JKS, 2021 WL 482513, (Bankr. Del. June 10, 2019), ECF No. 9, or the Debtors' Second Amended Combined Disclosure Statement and Joint Chapter 11 Plan of Liquidation, *In re: SportCo Holdings, Inc., et al.,* No. 19-11299-JKS, 2021 WL 482513, (Bankr. Del. Oct. 14, 2021), ECF No. 394, unless otherwise noted.

SportCo was majority owned by private equity firm Wellspring Capital Partners, and minority owned by investment firms Prospect Capital Corporation, Summit Partners Credit Fund, L.P. and certain members of the senior management team. As of the petition date, the funded indebtedness consisted of (1) approximately $23 million of first lien, asset based revolving credit facility debt ("ABL Debt") and (2) $230 million second lien term loan facility debt ("Term Loan Debt"; together with the ABL Debt, the "Secured Funded Debt"). In addition to the Secured Funded Debt, the debtors had approximately $41 million of unsecured debt comprised mostly of professional services, trade, and employee severance claims. The chapter 11 cases were funded by a roll up ABL debtor-in-possession facility from the existing ABL lenders. The chapter 11 cases were "free-fall" cases, as there was no restructuring support agreement with any of the holders of the Secured Funded Debt, nor was there a stalking horse agreement providing for the sale of substantially all of SportCo's assets.

Ultimately, following the liquidation of SportCo's assets in the chapter 11 cases, the ABL Debt and DIP Debt were repaid in full, approximately 14% of the Term Loan Debt was repaid, and unsecured claims and the deficiency Term Loan Debt claims (i.e., the remaining portion of the debt remaining after the collateral was sold and the proceeds applied in accordance with the secured claim waterfall) shared in the proceeds of estate causes of action assigned to a litigation trustee. In November of 2019, SportCo's plan of liquidation was confirmed, and in April of 2020, the litigation trustee filed a complaint against certain Wellspring Capital entities and certain of the former directors and officers asserting various causes of action against them.[17]

The claims asserted by the litigation trustee included claims against certain directors and officers for breach of their fiduciary duties of care and loyalty for rejecting an out-of-court restructuring proposal because it did not contain releases and indemnification for the directors and officers of SportCo. The complaint stated that the D&O Defendants, all of whom were employees of Wellspring or SportCo and not independent, engaged in discussions with the holders of Term Loan Debt regarding a potential restructuring before the bankruptcy filing.[18] The trustee's complaint asserted that "[t]he D&O Defendants, refused at the last minute, to execute any debt restructuring agreement premised on an out-of-court balance sheet restructuring that did not include a broad release and indemnification language in favor of the D&O Defendants and Wellspring Capital because they, and not the debtors' creditors, stood to receive substantial value if the debtors' debt restructuring agreement included [those] provisions."[19] The complaint further asserted that in insisting on such provisions, the D&O Defendants "placed their own self-interests above those of their fiduciaries — specifically, the debtors — and permitted the debtors to breach their loan covenants instead of entering into a restructuring agreement that did not provide the D&O Defendants or Wellspring Capital with the releases and the benefit of indemnification." [20]

In dismissing the trustee's breach of the duty of care claim, the bankruptcy court found that "the Complaint does not allege facts that would support the conclusion that the D&O Defendants failed to inform themselves adequately in rejecting the proposed out of court restructuring or that such action amount[ed] to gross negligence."[21] However, the bankruptcy court denied the D&O Defendants' request to dismiss the breach of the duty of loyalty claim, rejecting the D&O Defendants' argument that the "individual releases would not have been a 'private interest' because the benefit would have been shared with restructured SportCo . . . [by] sav[ing] the post-restructuring company the expense of indemnifying the D&O Defendants in connection with any litigation that would arise following a change of control in connection with a restructuring."[22] Instead, the bankruptcy court found that "the extent to which individual releases might have benefitted SportCo is a partly factual question because it involves the nature and extent of the D&O Defendants' entitlements to indemnification and other matters this Court cannot now resolve."[23]

Toys "R" Us

Ongoing litigation arising from the Toys "R" Us bankruptcy cases also highlights the risk of breach of fiduciary duty litigation against directors and officers in connection with restructuring decisions that arguably result in suboptimal outcomes for junior creditors,

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[17] Complaint, *Ronald Friedman v. Wellspring Capital Management, et al.* (In re: SportCo Holdings, Inc., et al.), No. 20-50554-JKS (Bankr. Del. Apr. 2, 2020), ECF No. 1.

[18] *Id.* at ¶¶ 129-134.

[19] *Id.* at ¶ 166.

[20] *Id.* at ¶ 168.

[21] *In re Sportco Holdings, Inc.*, 2021 WL 4823513 (Del. Bankr. Oct. 14, 2021), at *10.

[22] *Id.*

[23] *Id.* The docket in the adversary proceeding suggests that the parties are in mediation with respect to the breach of the duty of loyalty claim that survived the defendants' motion to dismiss.

particularly with the benefit of hindsight.[24] Like the SportCo chapter 11 cases, the Toys "R" Us bankruptcy cases were "free-fall" cases and, like in SportCo, the unsecured creditor claimants' recovery was significantly impaired and in large part limited to proceeds from estate causes of action. At a very high level, the Toys "R" Us enterprise consisted of three different (but at times, overlapping) debtor and accompanying creditor groups: (1) Toys "R" Us Inc. and certain direct and indirect subsidiaries (collectively, but excluding the Toys Delaware Debtors (as defined below), the "TRU Debtors"), which constituted the U.S business and included indirect ownership of the Toys "R" Us trademarks and other intellectual property (which were held by Toys "R" Us - Delaware Inc. and certain of its direct and indirect subsidiaries (collectively, the "Toys Delaware Debtors")); (2) Propco I and Propco II (the "Propco Debtors"), consisting of owned real estate that was leased to affiliates; and (3) TRU Taj LLC and certain direct and indirect subsidiaries (collectively, the "Taj Debtors"; together with the TRU Debtors, the Toys Delaware Debtors, and the Propco Debtors, the "Toys Debtors") consisting of the international subsidiaries. Combined, the Toys Debtors had in excess of $5 billion of funded debt obligations. The TRU Debtors and Taj Debtors chapter 11 cases were filed on September 18, 2017. Two independent directors were appointed to the TRU Board on September 13, 2017 for the purpose of taking control of decisions for which the other directors would have conflicts of interest. Note that the chapter 11 filings were precipitous, and in large part due to news reports that Toys "R" Us had engaged restructuring advisors and was considering restructuring options, which caused suppliers to begin to pull trade credit and withhold products amid generally tighter liquidity conditions and right before the holiday inventory build.

As part of the Toys Delaware Debtors and TRU Debtors respective chapter 11 plans, certain general, unsecured, and administrative expense creditors of the Toys Delaware Debtors and TRU Debtors received as part of their recovery interests in a litigation trust (the "TRU Creditor Litigation Trust"), which was formed to prosecute estate causes of action against the TRU Debtors' directors and officers. On March 12, 2020, the TRU Creditor Litigation Trust filed a complaint against certain TRU D&Os (the "TRU D&O Defendants") alleging various claims, including breach of fiduciary duty of care and loyalty claims relating to the TRU Board's decision to incur $3.1 billion of debtor-in-possession financing to fund a plan process premised on the Toys Debtors emerging from bankruptcy as a going concern rather than a "structured wind-down."[25] The crux of the complaint asserted that the Board's decision to pursue a going concern restructuring process was an "irrational" gamble that was driven by the TRU D&O Defendants' personal interests rather than based on an informed analysis to pursue a path forward that would "maximize the value of the enterprise for TRU's creditors."[26]

The TRU Creditor Litigation Trust also asserted breach of fiduciary duty claims against the TRU D&O Defendants for (1) authorizing pre-petition retention payments to company executives before the commencement of the Bankruptcy Proceeding[27] and (2) authorizing the payment of advisory fees to TRU's private equity shareholders from the fourth quarter of 2014 through the first quarter of 2017.[28] In addition to breach of fiduciary claims, the TRU Creditor Litigation Trust asserted claims for intentional or negligent misrepresentation, fraudulent concealment, or negligence on behalf of vendors based on allegations that the TRU D&O Defendants induced trade vendors to ship goods and provide services to TRU on credit after the commencement of the bankruptcy cases, the Defendants misrepresented facts concerning TRU's ability to make payments for those goods and services.[29]

The complaint further asserted that the Board and TRU's outside advisors were dominated by the TRU CEO director, whose desire to continue earning his $3.75 million salary and other perks, earn a $2.8 million retention bonus, as well protect the equity interests of Bain, KKR and Vornado (who he was allegedly beholden to), resulted in him dominating the Board and TRU's outside advisors to pursue a strategy that kept

[24] All background information related to Toys "R" Us was pulled from the Declaration of David A. Brandon, Chairman of the Board and Chief Executive Officer of Toys "R" US, Inc., In Support of Chapter 11 Petitions and First Day Motions, *In re: Toys "R" Us, Inc., et. al.*, No. 17-34665-KLP (Bankr. E.D. Va. Sept. 19, 2017), ECF No. 20, or the Second Amended Disclosure Statement for the Joint Chapter 11 Plan of the TAJ Debtors and the TRU Inc. Debtors, , *In re: Toys "R" Us, Inc., et. al.*, No. 17-34665-KLP (Bankr. E.D. Va. Sept. 6, 2018), ECF No. 4552 unless otherwise noted.

[25] The complaint was amended twice. All citations refer to the Second Amended Complaint filed on April 30, 2021 in the United States Bankruptcy Court for the Eastern District of Virginia under the case caption, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* Case No. 17-34665-KLP.

[26] *Id.* at ¶ 171.

[27] *Id.* at ¶¶ 75-89.

[28] *Id.* at ¶¶ 45-55.

[29] *Id.* at ¶¶ 90-118.

TRU alive as long as possible.[30] The complaint alleged that as a result of such domination, the Board did not request advice from its advisors on a wind-down strategy or any other alternative to a large-scale DIP financing, and that failure to do so was a "particularly egregious" abdication of the duty of care "because the DIP financing path was not a plausible strategy and would almost certainly result in the liquidation of TRU anyway, after destroying value and depriving unsecured creditors of access to hundreds of millions of dollars of unencumbered assets to at least partially satisfy their claims."[31]

The TRU D&O Defendants filed a motion to dismiss the complaint and, rather than rule on the motion to dismiss, the bankruptcy court treated the motion as a motion for summary judgment.[32] In their motion for summary judgment, the TRU D&O Defendants made various arguments in support of dismissal of the breach of duty of care and loyalty claims relating to the TRU Board's decision to incur the DIP financing and pursue a going concern restructuring, including that DIP financing related claims are barred by the "law of the case" doctrine as a result of the final DIP order's determination that the DIP financing was "fair and reasonable" and "reflect[ed] the [Debtors'] exercise of prudent business judgment consistent with their fiduciary duties."[33] The defendants also argued that because the official committee of unsecured creditors supported the DIP financing, the trust, which represented the same constituency, should be estopped from "advanc[ing] the opposite argument."[34] In its opposition brief, the TRU Creditor Litigation Trust contended that the bankruptcy court's October 2017 order finding that the DIP financing was "'necessary and vital" to preserve Toys' going-concern value is not "law of the case" because the confirmation order bars the application of any preclusion doctrine and expressly preserves the trust's claims against officers and directors, and that the claims are not precluded because the bankruptcy court approved the DIP orders based on "false and misleading information" furnished by the debtors and their advisors.[35]

On June 27, 2022, the U.S. Bankruptcy Court for the Eastern District of Virginia entered an order and memorandum opinion granting the TRU D&O Defendants' motion for summary judgment to dismiss the cause of action for breach of fiduciary duty for authorizing DIP financing, but denying the motion for summary judgment to dismiss with respect to other breach of fiduciary causes of action and the vendor inducement-related claims for intentional or negligent misrepresentation, fraudulent concealment, or negligence.[36] With respect to the breach of fiduciary duty for authorizing DIP financing claim, the bankruptcy court found that the final DIP order's findings that the DIP financing was "necessary and vital to the preservation and maintenance of the going concern values of the DIP Loan Parties and to a successful reorganization" and that the terms were "fair and reasonable, reflect the DIP Loan Parties' exercise of prudent business judgment consistent with their fiduciary duties and constitute reasonably equivalent value and fair consideration" were binding findings under the "law of the case doctrine."[37] In applying the "law of the case doctrine," the bankruptcy court explained that the TRU Creditor Litigation Trust offered "no 'new evidence' that, in the view of the bankruptcy court, was not available through discovery and that could have been offered prior to entry of the Final DIP Order."[38]

With respect to the other claims against the TRU D&O Defendants, the bankruptcy court found that the plaintiffs had submitted sufficient evidence such that there was a genuine dispute and trial issuable of fact with respect to the allegations underlying such claims. Notably, with respect to the breach of fiduciary duty claim for approving retention bonuses to 117 TRU executives, the bankruptcy court found that TRU Creditor Litigation Trust "documented extensive evidence and supporting case law" in support of its argument that, among other things, the "Defendants were not disinterested, failed to consider material

[30] *Id.* at ¶¶ 180-192.

[31] *Id.*

[32] Order, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* No. 17-34665-KLP (Bankr. E.D. Va. Sept. 30, 2020), ECF No. 65.

[33] Defendant's Motion and Memorandum of Law for Summary Judgement, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* No. 20-03038-KLP (Bankr. E.D. Va. Dec. 13, 2021) ECF No. 315 at pg. 5-8.¶.

[34] *Id.* at pg. 7.

[35] Trust's Opposition to Defendants' Motion for Summary Judgment, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* No. 20-03038-KLP (Bankr. E.D. Va. Jan. 18, 2022), ECF No. 343 at pg. 79-81; 85-86.

[36] TRU Creditor Litig. Tr. v. Brandon, et al. (In re Toys "R" Us, Inc.), Ch. 11 Case No. 17-34665-KLP, Adv. Pro. No. 20-03038-KLP, slip op. (Bankr. E.D. Va. June 27, 2022).

[37] *Id.* at pg. 6-7.

[38] *Id.* at pg. 19.

information reasonably available to them, failed to consider reasonable alternatives, and abdicated decision-making process to Defendant Brandon, the CEO of Tru, who was the recipient of the largest bonus."[39]

CONCLUSION: THE ROLE OF INDEPENDENT DIRECTORS IN MITIGATING D&O LIABILITY RISK

Toys "R" Us and SportCo underscore the risk of litigation against directors and officers in connection with their restructuring-related decisions when their corporations ultimately file for chapter 11, and the unsecured creditor recovery (without resort to estate causes of action) is minimal. When developing a governance strategy for a distressed company, the Board and its advisors must consider the "worst case" restructuring outcome and how the directors' and officers' decisions may be viewed in hindsight by creditors that suffer losses as a result of decisions made or approved by the Board. Although litigation may be an inevitability as a result of a business-driver restructuring outcome, decisions related to Board processes in assessing restructuring options and negotiating with creditors and other key stakeholders, will help develop a record to insulate the Board from ultimate liability (and could prevent litigation itself from being brought in the first place or significantly reduce the perceived merits and settlement value of such litigation).

Indeed, the breach of duty of loyalty claim in *SportCo* may have been dismissed if an experienced independent director was on the Board (as opposed to no independent director, as was the case there). Ideally, that independent director would have had (1) "actual bargaining power without interference and the real ability to decide whether to accept or reject the terms of an offer" and (2) sufficient resources to undertake a robust analysis demonstrating a thorough assessment of downside risks.[40] The SportCo bankruptcy court found that the litigation trustee pled facts sufficient to show that releases and indemnification were restructuring terms constituting private interests of the very directors negotiating the restructuring on behalf of SportCo. The result may have been different if the SportCo Board would have been further insulated by forming a special committee consisting of one or more independent directors vested with the exclusive authority to negotiate and approve the terms of a restructuring transaction.

In contrast to the SportCo Board, there were two independent directors on the TRU Board. Although authority to enter into the DIP financing and negotiate the terms of a restructuring was not vested exclusively with the independent directors, the decision to obtain DIP financing and pursue a going concern restructuring were not "interested transactions" for the non-independent directors approving the relevant transactions. Yet, the TRU Creditor Litigation Trust still alleged that the Board was compromised by the insider CEO, and that his economic self-interest drove the TRU Board's restructuring strategy. Although the cause of action for breach of fiduciary duty for authorizing DIP financing was dismissed on the grounds that it was precluded by the final DIP order findings, the TRU Creditor Litigation Trust's lawsuit underscores the potential exposure director and officers face as a result of bankruptcy liability management decisions if their decisions are not unilaterally made by disinterested independent directors (or otherwise subsequently blessed by bankruptcy court order). Absent exclusive decision-making authority by the independent director, the corporate governance record should ideally show that the independent director is leading the decision-making process, including overseeing analysis from outside professional advisors. In addition, the summary judgment denial for the tort causes of action in respect of vendors allegedly being induced to provide credit based on misrepresentations underscores the risks that directors and officers face when dealing with trade creditors in the lead up to a bankruptcy filing. Finally, SportCo and Toys "R" Us are cautionary tales. The litigation posture of the Board in both of these cases would have been vastly improved with a properly inserted, and the timely appointment of, an independent director or special committee of the Board. ■

[39] *Id.* at pg. 21.

[40] *See, e.g.*, *Rabkin*, 1990 WL 47648, at *861-62, aff'd 586 A.2d at 1202. For example, in connection with the Purdue Pharmacy chapter 11 cases, prior to filing for bankruptcy, Purdue Pharma's governance documents were amended to "irrevocably grant[] an independent Special Committee of the Board of Directors exclusive authority over the prosecution, defense, and settlement of any causes of action Purdue Pharma may assert against its shareholders, as well as members of the Sackler Families and their affiliates." See Debtors' Amended Disclosure Statement, *In re Purdue Pharma L.P.*, 19-23649-RDD (Bankr. S.D.N.Y. May 26, 2021), ECF No. 2937, at 68.